Microsoft

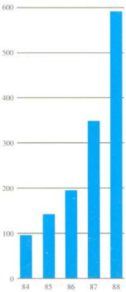
Corporation

1988 Annual Report

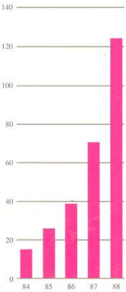
Microsoft

(In thousands, except net income per share)	Year Ended June 30				
	1988	1987	1986	1985	1984
For the year					
Net revenues	$590,827	$345,890	$197,514	$140,417	$97,479
Net income	123,908	71,878	39,254	24,101	15,880
Net income per share	2.22	1.30	0.78	0.52	0.35
At year-end					
Working capital	$227,827	$164,353	$118,452	$41,442	$21,458
Total assets	493,019	287,754	170,739	65,064	47,637
Stockholders' equity	375,498	239,105	139,332	54,440	30,712
Key ratios					
Current ratio	2.9	4.4	5.0	4.9	2.3
Return on net revenues	21.0%	20.8%	19.9%	17.2%	16.3%

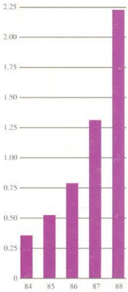
Net Revenues
(In millions)

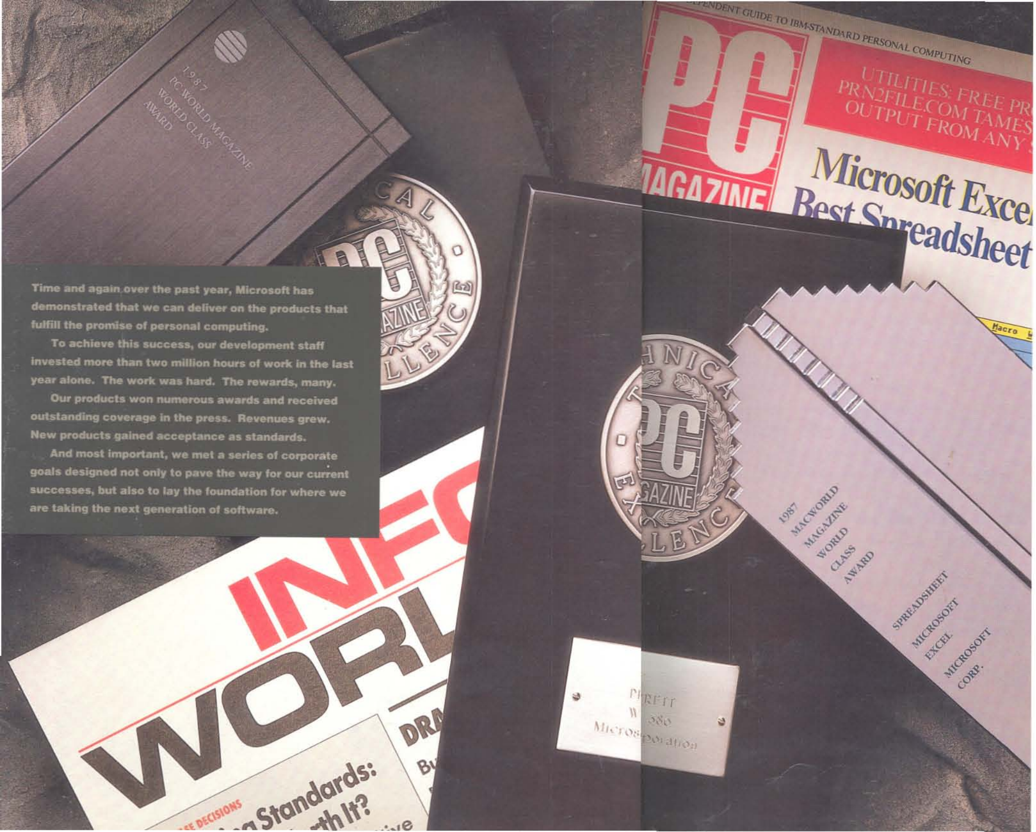


Net Income
(In millions)



Net Income Per Share





Time and again over the past year, Microsoft has demonstrated that we can deliver on the products that fulfill the promise of personal computing.

To achieve this success, our development staff invested more than two million hours of work in the last year alone. The work was hard. The rewards, many.

Our products won numerous awards and received outstanding coverage in the press. Revenues grew. New products gained acceptance as standards.

And most important, we met a series of corporate goals designed not only to pave the way for our current successes, but also to lay the foundation for where we are taking the next generation of software.

IBM® PC applications

Microsoft® Excel
Best New Products of 1987 *Business Week*
Award for Technical Excellence *PC Magazine*
Best MS-DOS® Software Product of the Year *InfoWorld*
Best Spreadsheet *InfoWorld*
Best of 1987 *PC Magazine*
Rated #1 spreadsheet *Datapro Research Corporation*
Excellence in Software *Software Publishers Association*

Microsoft Word 4.0
Top 100 *InfoWorld*
Best of 1987 *PC Magazine*
Editor's Choice *PC Magazine*
Excellence in Software *Software Publishers Association*

Microsoft Works
Top 100 *InfoWorld*
Editor's Choice *PC Magazine*
Best of 1987 *PC Magazine*
Best Integrated Software *InfoWorld*
Excellence in Software *Software Publishers Association*

Microsoft Project
Best Project Management Software *InfoWorld*
Rated #1 project manager *Datapro Research Corporation*

Microsoft Multiplan®
Top 100 *InfoWorld*

Microsoft Flight Simulator®
1987 World Class Survey *PC World*

Microsoft Learning DOS
1987 World Class Survey *PC World*

Apple® Macintosh® applications

Microsoft PowerPoint®
Best Desktop Presentations Product of 1987 *MacUser*

Microsoft Mail
Best New Desktop Communications Product of 1987 *MacUser*
Excellence in Software *Software Publishers Association*

Microsoft Excel
1987 World Class Award *MacWorld*

Microsoft Word
Best Macintosh Word Processing Software *InfoWorld*

Microsoft Works
Best Integrated Product of the Year *InfoWorld*
User's Choice Award *MacWorld*

Systems and languages

Microsoft Windows 2.0
1987 World Class Survey *PC World*
Best of 1987 *PC Magazine*
Rated #1 in environment category *Datapro Research Corporation*

Microsoft Windows/386
Best of 1987 *PC Magazine*
Award for Technical Excellence *PC Magazine*
1987 World Class Survey *PC World*
Excellence in Software *Software Publishers Association*

Microsoft OS/2
Excellence in Software *Software Publishers Association*

MS® OS/2 Software Development Kit
Best of 1987 *PC Magazine*

LIM 4.0
(Lotus-Intel-Microsoft standard for expanded memory)
Best of 1987 *PC Magazine*
(shared with Lotus and Intel)
Award for Technical Excellence *PC Magazine*
(shared with Lotus and Intel)

Microsoft QuickBASIC 4.0
Award for Technical Excellence *PC Magazine*
Best of 1987 *PC Magazine*

Microsoft QuickC®
Excellence in Software *Software Publishers Association*

Microsoft BASIC Interpreter
for the Apple Macintosh
1987 World Class Award *MacWorld*

Hardware and CD-ROM

Microsoft MACH 20™
Best of 1987 *PC Magazine*

Microsoft Mouse
Top 100 *InfoWorld*
Best of 1987 *PC Magazine*
Design Achievement *Industrial Designers Society of America*
Editor's Choice *PC Magazine*
1987 World Class Survey *PC World*

Microsoft Bookshelf
Best of 1987 *PC Magazine*

To Our Shareholders:

We have completed another successful year.

A year in which we introduced 43 new and enhanced products. Delivered our first version of an important new operating system. And delivered the first application built around the new graphics-based platform represented by that operating system.

It was a year in which our products won dozens of awards and received hundreds of excellent reviews.

And a year in which we became the first microcomputer software company to earn more than $100 million in revenues in a single quarter. A record we have maintained for four consecutive quarters.

Revenues for the year equaled $590.8 million, a 71 percent increase over fiscal 1987 revenues of $345.9 million.

Both net income and net income per share reached record highs, in line with revenue growth. Net income rose to $123.9 million, up from last year's $71.9 million, an increase of 72 percent. Net income per share was $2.22, an increase of 71 percent from the $1.30 recorded last year.

These results represent strong showings across all channels of distribution and in all product groups. Our International division was particularly strong, representing 48 percent of our business and making Microsoft's international presence greater than that of any other software company.

Retail revenues also grew significantly, demonstrating that we are meeting our goal of increasing our presence in the applications business.

Product Introductions and Announcements

It's been an active year.

The first release of the OS/2 operating system—a joint development effort by Microsoft and IBM—was delivered on schedule in December.

Microsoft® OS/2 represents a powerful new platform designed to make the most of the power of the latest microcomputers. It is already supported by manufacturers in the United States and abroad, including IBM, Acer, Compaq, Hewlett-Packard, NCR,

NEC, Olivetti, Philips, Tandy, and Zenith.

This first version of OS/2 lays the groundwork for the shipment of OS/2 with Presentation Manager (a graphics-based user interface) scheduled for later this year.

The Presentation Manager user interface is modeled on the Microsoft Windows interface, giving customers a series of visually oriented tools for controlling their computers. Two versions of Windows were released during the year: Microsoft Windows/386, which takes advantage of the special features of the computers designed around the Intel® 80386 microprocessor; and Microsoft Windows/286, designed for the broad base of IBM and compatible personal computers built around the Intel 80286 chip.

The release of OS/2 provides the foundation for Microsoft OS/2 LAN Manager, an advanced local area networking system that will lead to a new era of office-based applications. More than 70 independent companies announced plans to license Microsoft OS/2 LAN Manager or develop software for it.

During the year, we began shipping OS/2 versions of Microsoft C Optimizing Compiler, Macro Assembler, BASIC Compiler, FORTRAN, COBOL, and Pascal, and we announced that our current applications products, including Microsoft Multiplan and the next version of Microsoft Word, will be designed to run under both the MS-DOS and OS/2 operating systems.

These announcements demonstrate our Company's commitment to the course we have charted with OS/2.

During the year we shipped several new business applications designed for IBM Personal Computers and compatibles.

Microsoft Excel for Windows, the first spreadsheet designed for today's new generation of personal computers and the Company's first application designed for the Windows interface, has gained growing acceptance in the market.

Business Week hailed Microsoft Excel as one of the best new products of 1987. And *PC Magazine* gave Microsoft Excel its award for technical excellence.

In April, we extended our guarantee program for Microsoft Excel through January 1990. This guarantee allows customers to select our spreadsheet now and still review any competitive offerings, risk-free, during the next year.

Microsoft Word was updated during the year, underscoring our commitment to the word processing market. We provided additional support for Word by releasing Microsoft Pageview, a Windows-based application that gives a full-page preview of Word

Jon A. Shirley *William H. Gates*

documents and helps users incorporate graphics more easily.

Microsoft Works, another important release, is a multi-purpose software package that combines word processing, a spreadsheet with charting, a database, and communications in a single, inexpensive program. This product represents a major new offering targeted at the growing small-business and home markets. We have entered into a joint promotion with IBM to provide copies of Microsoft Works to customers who select Model 25 of the IBM Personal System/2® series.

Several other software products for IBM and compatible computers—including Microsoft Chart, Microsoft Project, and Microsoft QuickBASIC—were updated. We also introduced Microsoft QuickC, which builds on our established reputation as the leading developer of the C language.

1988 Revenue by Product Group

Systems/Languages	47%
Applications	40%
Hardware, Books and Other	13%

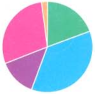
1987 Revenue by Product Group

Systems/Languages	49%
Applications	38%
Hardware, Books and Other	13%

1988 Revenue by Channel

Domestic OEM	17%
Domestic Retail	32%
International OEM	14%
International Retail	34%
Microsoft Press and Other	3%

1987 Revenue by Channel



Domestic OEM	21%
Domestic Retail	35%
International OEM	14%
International Retail	28%
Microsoft Press and Other	2%

The Microsoft Mouse pointing device was dramatically redesigned, demonstrating our commitment once again to the advancement of mouse technology. Total sales for the Mouse have now surpassed well over one million units.

We released Microsoft MACH 20, a performance enhancement board designed to bridge the gap between older hardware systems and newer computer technologies. A special Microsoft Excel/MACH 20 package allows customers with older machines to start using the new generation of software right away.

In the Macintosh arena, we maintained our leadership position and entered two major new categories with Microsoft PowerPoint, a desktop presentations program, and Microsoft Mail, an interoffice electronic mail program.

We announced major updates of several products for the Apple Macintosh that take advantage of new capabilities of the Macintosh interface, including color and the ability to display multiple applications simultaneously. Announcements included updated versions of Microsoft Word, Microsoft Excel, Microsoft File, and Microsoft PowerPoint. These announcements demonstrate our continuing commitment to the Apple Macintosh—a commitment that we were one of the first major software companies to make.

In the CD-ROM group, we shipped Microsoft Bookshelf, our first entry in the burgeoning CD-ROM (compact disc read-only memory) market, and we announced additional CD-ROM products including Microsoft Stat Pack and Microsoft Small Business Consultant. All these products take advantage of the ability of a CD-ROM drive to store enormous quantities of information and to access that information easily.

Microsoft Press® is the book publishing and CD-ROM product arm of the Company. The book publishing operation released 30 new titles and delivered record sales. Of the 90-plus titles published in its brief history, 35 have made best-seller lists for computer trade books. Microsoft Press books are printed in 15 languages and sold in more than 50 countries.

Business Activity

Microsoft continues to forge alliances designed to establish our strategic position within the industry.

One noteworthy agreement was announced in January, when we joined with Ashton-Tate to announce SQL Server, relational database server software for local area networks. Under the agreement, Ashton-Tate will license SQL Server from Microsoft for redistribution through retail channels, and Microsoft will license SQL Server to hardware manufacturers on an OEM basis. SQL Server represents a significant advance in the way applications programs talk to databases.

Microsoft participated in 14 conferences with IBM to educate more than 17,000 corporate customers about the OS/2 operating system. We also sponsored other well-attended events, ranging from a major product rollout for our dealers in the fall to CD-ROM and networking conferences later in the year.

As our business expanded, our facilities and staff grew to meet our changing needs. The Company now employs 2,800 people around the world. A major new manufacturing facility was completed in March, and we have begun construction on three new buildings at our corporate headquarters. Internationally, we added a new office in Spain and elevated our office in the Netherlands to full subsidiary status.

Recently, investors have asked a variety of questions about the March suit filed by Apple Computer, Inc., in federal court against Microsoft and Hewlett-Packard Company. In its complaint, Apple alleges that visual displays in Microsoft Windows version 2.03 infringe certain Apple copyrights, and Apple seeks to enjoin Microsoft from marketing the product and to recover damages in an unspecified amount.

We think that Apple's claims are precluded by a 1985 agreement between Apple and Microsoft and that, in any event, none of the visual displays in this product infringes upon any protectable proprietary interest of Apple. Accordingly, we consider the case to be without merit. We have filed our answer, with affirmative defenses and counterclaims, and intend to assert our defenses and prosecute our claims vigorously. The judge has granted our motion to divide the case into two phases: phase one, involving interpretation and enforcement of the 1985 agreement; and phase two, involving copyright issues. Discovery is limited at this time to the phase one case, scheduled for trial next summer.

We will continue our development and marketing efforts with Windows, Windows applications products, and Presentation Manager, as well as with our Macintosh applications products.

To summarize, this has been an unusually active year, and a notably successful one. Our revenues benefited from the rapid growth of personal computer hardware sales worldwide. If these sales level off over the year ahead, we would expect our own revenues to show more moderate growth.

We also expect revenues from packaged products to grow at a faster rate than royalty sales, which will cause an increase in our cost of goods sold as well as in marketing expenses. This change in our business is a key element in our long-term corporate strategy to establish the Company as a major player in the business applications market.

Research and development expenses will grow as a percentage of sales as we develop new applications for the MS-DOS and Macintosh environments and adapt current applications to OS/2 Presentation Manager. We will also continue to work on expanded versions of OS/2 and to extend our line of networking products.

This investment in R&D, we believe, is essential to maintaining the Company's long-term position of leadership within our industry, and to delivering on the strategies we have established as the leading developer and supplier of personal computer software.

Jon A. Shirley
President and
Chief Operating Officer

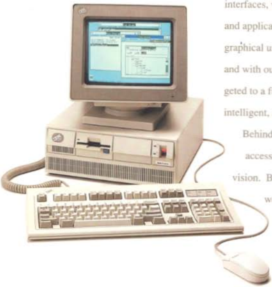
William H. Gates

William H. Gates
Chairman of the Board and
Chief Executive Officer

Microsoft develops software technologies that make the most of the latest hardware, advancing the state of the art while laying the groundwork for future advances.

Microsoft Operating System/2 with Presentation Manager, for example, establishes a new platform that gives customers an intuitive, visually oriented way to interact with computers.

This new systems technology will, in turn, allow the development of a new generation of applications that are consistent in design and easy to learn, yet powerful and well suited to the growing needs of corporations.



It's been an unusually active year. And a notably successful one.

The numbers, though, tell only part of the story. Because the real story of Microsoft isn't just in where we've been as a company—it's in where we're taking our entire industry.

We continue to look ahead to the day when there will be a computer on every desk and in every home.

To deliver on this vision, we have established a series of corporate strategies that are focused both on maximizing short-term gains and on positioning the Company for a continuing leadership role in the future of personal computing.

We expect that, over the next several years, customers will start looking beyond individual differences in software products and will instead evaluate the architecture underlying those products and how that architecture is integrated across software solutions.

The work we've already completed—with the development of OS/2 systems, with the Windows and Presentation Manager interfaces, with languages like Microsoft C Optimizing Compiler and applications products like Microsoft Excel, with advances in graphical user interfaces in both the IBM and Macintosh worlds, and with our mouse and other hardware technology—has been targeted to a future in which customers are offered a consistent, intelligent, and intuitive way to interact with computers.

Behind all this work is a commitment to make computers more accessible to more people. We believe we can deliver on this vision. Because over the past year, we have demonstrated that we have the business acumen and technical know-how to deliver products on time as well as to establish those products as standards.

Throughout these months, there have been many important activities and introductions. But a few milestone events deserve special attention.

Microsoft OS/2 and Presentation Manager

After we introduced the MS-DOS operating system in 1981, it was accepted as a technical standard that would forever change the shape of personal computing.

By design, Microsoft products bring the best-available technology to the broadest base of customers. To do that effectively, we need to give those customers the full support to make the most of their products.

Our product support telephone lines—open 12 hours each working day, from 9 A.M. on the East coast to 6 P.M. on the West coast—handled nearly 750,000 calls last year and as many as 92,000 calls in a single month.

We also introduced electronically based information services that allow instant access to a vast library of technical resources. These include Microsoft OnLine, designed for developers, as well as an end-user service on GE's GEnie™ consumer information network.

Since then, we have added features to MS-DOS that expand its capabilities. And we helped to advance the state of the hardware art by periodically modifying this very essential, very central piece of software.

But all along, we knew that progress in the next generation of computing—built around more powerful processors, greater memory, and improved graphics—would be possible only with a new operating system designed to make the most of this new hardware.

Enter Microsoft OS/2 with the Presentation Manager interface. Rather than getting wrapped up in the technical details that define an operating system and how it works, let's talk instead about OS/2 in human terms: how it will benefit the vast majority of computer users as individuals and in workgroup settings.

Consider, for example, the ability of OS/2 to run more than one application at a time—or what is called "multitasking." Technically, this is a major feat, since our developers had to figure out how to keep applications from stepping on each other, and how to keep the rest of the computer running if something went wrong with one of those applications.

To the customer, however, this new capability simply means that, for the very first time, personal computers can imitate how people already work. Moving from one job to another, quickly and seamlessly.

So you can calculate a series of figures on a spreadsheet. Chart those results for more effective presentation. Move your numbers and graphs into a report. Electronically transmit that report to your field offices. All without starting and stopping and restarting and restopping each of those individual programs.

You can run a word processor or spreadsheet in the foreground and be alerted to a meeting by a scheduling program or to a message by an electronic mail program running in the background.

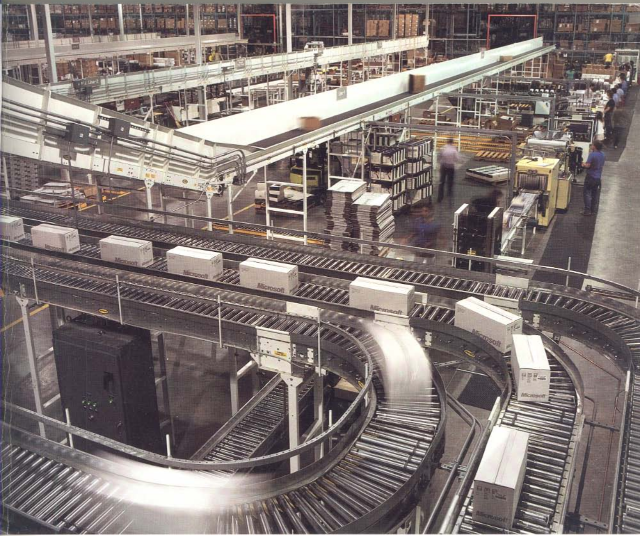
In essence, multitasking means that, for the first time, computers can really work like people. Instead of making people work like computers.

Successful companies need to take intelligent risks and not simply rest on past successes.

At Microsoft, we're committed to maintaining our leadership position in the market with strong competitive offerings that set the standards for our industry.

The Microsoft Mouse, for example, was already a major success—with more than a half-million units sold—when we introduced the dramatically redesigned mouse shown here.

The result? In just one year, sales of the Microsoft Mouse more than doubled our total sales since 1984, bringing us to a grand total of well over one million units sold.



As the packaged product sector of our business has grown, we have expanded facilities to keep pace with the resulting manufacturing and distribution needs, both domestically and internationally.

In April, we completed work on a 260,000-square-foot manufacturing facility, located 20 minutes north of our corporate headquarters. This new facility allows us to consolidate domestic manufacturing and distribution operations at a single site, and prepares us for future growth.

Manufacturing needs for the European market are met primarily through a major facility in Dublin, Ireland. Expansion this year will bring our manufacturing site in Ireland to 70,000 square feet.

This idea is also at the heart of another important technical advance of OS/2—the Presentation Manager interface—which is a visually oriented way for customers to interact with computers. Instead of requiring customers to learn convoluted sets of commands that are different for each program, OS/2 Presentation Manager makes every program operate in a common way.

So customers can get up to speed with new programs much more quickly than ever before. And since users aren't bogged down with figuring out the basics for each program, they can do much more with those programs, sooner than they could before.

This feature is also popular with corporate decision makers, who appreciate how this simple, consistent interface will save on training. And who recognize the importance of the fact that Presentation Manager is consistent with IBM's SAA standards, a series of guidelines that will be used in systems ranging from personal computers to mainframes.

What's more, since the OS/2 systems provide new networking tools—including OS/2 LAN Manager—that make it possible to connect people more efficiently than ever before, the flexibility that's possible on a single system can now extend across an entire office or throughout an entire company. So that information from different users in different places can be exchanged and combined easily.

The result is that workgroups will be able to work more efficiently than ever before.

And tools for those workgroup environments can be designed more easily now, too. Because programmers can focus on the content of their programs, instead of worrying about the details of designing and maintaining a unique user interface.

Microsoft Excel

To gain some insight into what kinds of applications are going to be possible under OS/2 with Presentation Manager, take a look at Microsoft Excel for Windows, our major new entry in the spreadsheet market.

Note that Microsoft Excel demonstrates how we as a company approach market challenges. Instead of producing just another

An important strategy over the past year has been to develop and maintain strong relationships with several major accounts.

To do this successfully, we need to demonstrate to these customers not only that our individual products outperform competitive offerings in the market, but also that these products establish a new software architecture that defines the next generation of computing.

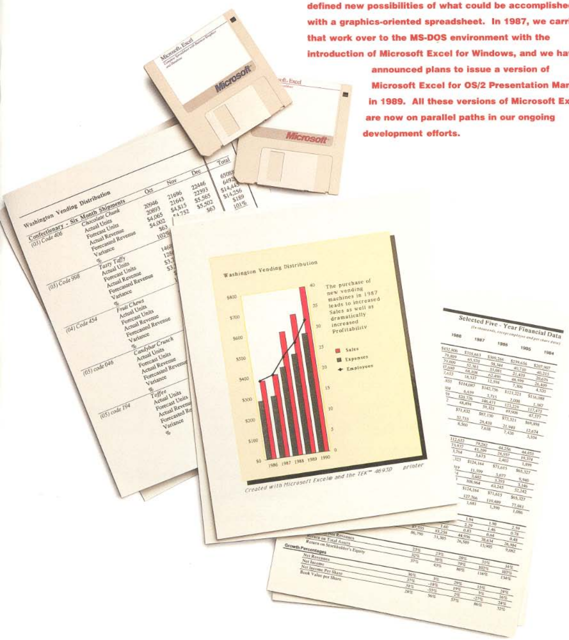
One such relationship was established in March, when the accounting firm of Arthur Andersen finalized a purchasing agreement with the Company in which the firm agreed to acquire more than 4,000 units of Microsoft Excel for Windows over the next two years.

Similarly, Visa Corporation has decided to use Microsoft Word in its corporate headquarters and in outlying offices.

As a Company, we are determined to develop and ship top-quality products in a timely fashion, leveraging our strengths across multiple hardware environments.

Our proprietary technical development tools make it possible for different applications to share large blocks of code. Which means that programs can be written faster. And software features can easily be translated from one hardware platform to another.

In 1985, for example, Microsoft Excel for the Macintosh defined new possibilities of what could be accomplished with a graphics-oriented spreadsheet. In 1987, we carried that work over to the MS-DOS environment with the introduction of Microsoft Excel for Windows, and we have announced plans to issue a version of Microsoft Excel for OS/2 Presentation Manager in 1989. All these versions of Microsoft Excel are now on parallel paths in our ongoing development efforts.



An important goal for our Company has been to build on our established strengths worldwide, making the international market an integral part of our product planning and development process.

We've met this goal with notable success. Over the past fiscal year, nearly half our total revenues were generated outside the United States. Our subsidiaries in Germany and France together did nearly twice as much business in the past 12 months than all of Microsoft in fiscal year 1983.

And our future products are being developed with the international market in mind. Windows and OS/2, for example, are designed so that applications created in these environments can be easily translated into foreign languages. Last year, we delivered 220 localized versions of our products for the international market.

"me-too" spreadsheet that mimics other entries in this category, we set out to produce a competitive spreadsheet product that dramatically advances software technology while fitting precisely into the architecture we are molding for the next generation of computing.

Microsoft Excel is a good example of how the next generation of software will perform. In addition to simplifying learning and training, the visually oriented interface of Microsoft Excel allows for many exciting features: outstanding business graphics; elaborate on-the-screen displays that match exactly what the customer gets from the printer; sophisticated customization tools; and business analysis functions that make it easy to get inside what the numbers really mean.

Microsoft Excel has been designed to perform consistently across multiple environments, including Windows, OS/2 Presentation Manager, and the Macintosh. Although some important technical differences are at work behind the scenes, this consistent approach ultimately means that more people will have more access to the power of their machines.

Future business applications created for OS/2 Presentation Manager will benefit from similar advantages. Word processors, for example, will be able to combine all sorts of information from all sorts of programs, and then display that information on screen exactly as it will appear on paper. Project management software will give customers visual displays of their project plans at any level of detail they need. Database software will replace complex programming steps with simple ways to get to complex data banks.

In short, our commitment to this interface ultimately means that we are doing more than improving the state of our business. We are also advancing the state of our art.

International Implications

The international market is such an important part of our business—representing nearly half of total revenues—that any steps we take to advance the state of the art must also be examined in terms of how they will affect the state of technology abroad.

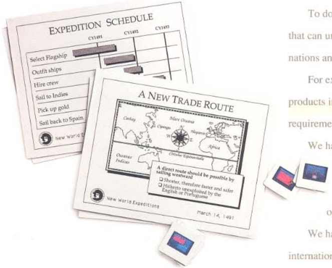
That's one reason, for example, that we made the technical decision that Windows and OS/2 Presentation Manager would

To take advantage of opportunities in the fast-growing software industry, we have entered new product categories through strategic acquisitions.

The products we select are chosen to complement our current product line, and to provide both technical and marketing foundations for future product efforts.

For example, we established our foothold in the booming desktop presentations market (expected to triple over the next three years) by acquiring Forethought, the producer of PowerPoint, which is the first program expressly designed to produce overheads and slides.

And we laid the foundation for our office automation strategy with the acquisition of Microsoft Mail, an electronic mail product for the Macintosh that began shipping in December.



separate how commands are displayed on the screen from the main core of the program. So translations to those commands can be made simply, by changing a special "resource file," rather than requiring the programmer to go into the heart of the software and make changes in the core code.

This means that products developed for one country can be localized for another country more easily and more quickly than ever before.

Once again, this is a technically important advance. But even more important are the decisions behind that advance.

At Microsoft, our International group plays an integral role in all our product decisions—right from the start. Products are developed with an eye to how they will be received abroad, as well as to how they will perform in the American market.

U.S. sales of personal computers now represent only 40 percent of the total world market. What's more, international sales are increasing at an ever-faster rate, creating major opportunities for growth and making this an important market in which to position our company for the future.

To do that, we have established ourselves as the one company that can understand and deliver on the unique needs of many nations and cultures.

For example, we have produced localized versions of our products in languages that have very different display requirements—Arabic and Chinese, for example.

We have established important strategic alliances with hardware partners around the world through international distribution of MS-DOS and the OS/2 operating systems.

We have aggressively sought to maintain our rights to international copyrights and distribution channels for our software products, as in this year's decision by the Brazilian government to allow distribution of the MS-DOS operating system in that country.

And we have set out to develop relationships in areas that we believe will ultimately represent new market opportunities, as

represented by our sales and marketing efforts in several Eastern bloc countries.

In short, in everything we've done as a company—from the design of our software to the market positioning of our individual products—we have set out to establish ourselves as a truly international software company.

Preparing for the Next Decade

Despite the fact that personal computers have been around for more than a dozen years, despite the fact that this technology provides the foundation for a multibillion dollar industry worldwide, and despite the fact that many people could benefit from this technology, the simple truth is that most people have still never used a personal computer.

In that simple truth, there is opportunity, and there is challenge.

Opportunity, in that the worldwide market for personal computer software can continue to grow in the years ahead, as more people discover how this technology can benefit them personally.

Challenge, in that market leaders such as Microsoft need to create the tools that deliver on those opportunities.

As a company, we have established many strategies that are designed to make the most of current opportunities and to build for the future.

But we can reach that future only if we develop quality products, built around a consistent architecture, with high-quality manufacturing and support.

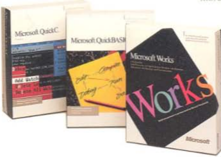
It's a tall order. And a complex challenge, which requires us to advance technology to meet the needs of the market. To translate the importance of that technology to our customers. And to deliver on the promise of that technology to customers around the world.

Microsoft is the one company that is determined to make it all make sense.

To stay on top in the ever-expanding software business, the Company has sought to establish itself in new markets with products intelligently targeted at customers.

Microsoft Works, for example, is an all-in-one package that combines word processing, spreadsheet, database, and communications modules in a single program. Designed for the home-business and small-business markets, Microsoft Works is an ideal software complement to the new, lower-priced hardware that became available during the past year.

Similarly, Microsoft QuickC and Microsoft QuickBASIC language products are targeted at the growing base of recreational programmers who don't need the functionality and high-end performance features of our professional language offerings.



At Microsoft, people are our most important resource. To help attract and bring on board the best and the brightest employees, we have created an attractive campus setting at our Redmond, Washington, headquarters.

We've also created a dynamic working environment that challenges our employees to do their best work, on products that will have a dramatic impact on our industry and society.

Today, Microsoft employs more than 2,800 people worldwide. To keep pace with growth, we are adding three new buildings, scheduled for completion late in 1988. This will bring us to a total of nine buildings at headquarters, providing 670,000 square feet of space at our 125-acre site.

Microsoft markets a complete line of business applications, language products, and hardware available from dealers worldwide.

	Operating System			
	OS/2	MS-DOS	Apple Macintosh	XENIX®
Business application software				
Microsoft Chart		•	•	
Microsoft Excel		•	•	
Microsoft File			•	
Microsoft Learning DOS		•		
Microsoft Mail			•	
Microsoft Multiplan	•	•	•	•
Microsoft Pageview		•		
Microsoft PowerPoint			•	
Microsoft Project		•		
Microsoft Word	•	•	•	•
Microsoft Works		•	•	
Microsoft Write			•	
System/Language software				
Microsoft BASIC	•	•		•
Microsoft C	•	•		•
Microsoft COBOL	•	•		•
Microsoft FORTRAN	•	•		•
Microsoft GW-BASIC®		•		
Microsoft Macro Assembler	•	•		•
Microsoft Pascal	•	•		•
Microsoft QuickBASIC		•	•	
Microsoft QuickC		•		
Microsoft Windows/286		•		
Microsoft Windows/386		•		
Hardware				
Microsoft MACH 20	•	•		
Microsoft MACH 20 Memory Plus	•	•		
Microsoft MACH 20 Disk Plus	•	•		
Microsoft Mouse	•	•		
CD-ROM				
Microsoft Bookshelf		•		
Recreational				
Microsoft Flight Simulator		•	•	
Support				
Microsoft OnLine				

Microsoft markets many additional products—such as the OS/2, MS-DOS, and XENIX operating systems and the OS/2 LAN Manager—through hardware manufacturers worldwide.

Microsoft

Corporation

1988

Financial

Results

(In millions)

Net Revenues

	1988	% Change	1987	% Change	1986
Net revenues	$590.8	71	$345.9	75	$197.5

Annual increases in the Company's net revenues have been a result of several factors, including the introduction of new products and enhancements to existing products, the expansion of the Company's foreign operations and export sales, and the general expansion of the market for microcomputer software. During 1988, the Company was able to continue its pattern of steady revenue growth in all product groups and across all channels of distribution, both domestically and internationally.

New products that began shipping during 1988 included Microsoft Excel, Microsoft Works, and Microsoft QuickC for IBM and compatible computers; Microsoft PowerPoint, Microsoft Write, and Microsoft Mail for Apple Macintosh systems; Microsoft Bookshelf for CD-ROM systems; Microsoft OS/2 Programmer's Toolkit; and Microsoft MACH 20. In addition, many existing products were significantly enhanced during 1988.

Significant new or enhanced products for 1987 included Microsoft Learning DOS, Microsoft Multiplan 3.0, Microsoft FORTRAN 4.0, and Microsoft QuickBASIC 3.0 for IBM and compatible computers; Microsoft Works and Microsoft Word 3.0 for Apple Macintosh systems; and Microsoft Mouse 6.0.

International net revenues for fiscal years 1988, 1987, and 1986 were $282.3 million, $146.2 million, and $80.0 million. These amounts represented 47.8%, 42.3%, and 40.5% of total net revenues for the respective years. This growth was a result of several factors, including successful product localization, expansion to additional foreign markets, and favorable foreign currency exchange rates. For additional information concerning foreign operations and export sales, see page 32.

Cost of Revenues

	1988	% Change	1987	% Change	1986
Cost of revenues	$148.0	100	$73.9	81	$40.9
Percentage of net revenues	25.0%		21.4%		20.7%

The 1988 increase in cost of revenues as a percentage of net revenues is a result of numerous factors, including a shift in the revenue mix to a greater contribution from packaged product, a significant increase in lower profit margin revenue from product updates, an increase in product material costs, and price reductions on select products due to strategic or competitive factors. Management expects revenues from packaged product to continue to grow at a faster rate than royalty revenues, which will cause an increase in cost of revenues as a percentage of net revenues.

Operating Expenses

	1988	% Change	1987	% Change	1986
Research and development	$ 69.8	83	$38.1	86	$20.5
Percentage of net revenues	11.8%		11.0%		10.4%
Sales and marketing	$161.6	90	$85.1	48	$57.7
Percentage of net revenues	27.4%		24.6%		29.2%
General and administrative	$ 24.0	9	$22.0	25	$17.6
Percentage of net revenues	4.1%		6.4%		8.9%

Research and development expenses encompass primarily compensation and facility costs for internal development, cost of freelance developers, and acquired intellectual property rights. Research and development expenses have increased as a result of (1) additions to the Company's software development staff, (2) expenses related to product localization, and (3) amortization of the cost of acquired intellectual property rights. Management presently anticipates that research and development expenses will continue to grow at a faster rate than net revenues.

Sales and marketing expenses include compensation, travel, and facility costs for the Company's sales and product support personnel and marketing and advertising costs. The growth in these expenses reflects the continuing expansion of the Company's domestic and international sales and marketing staff, increased marketing and advertising expenditures, and increased cooperative marketing and promotional activities.

The increase in general and administrative expenses is primarily attributable to the growth in administrative staff and systems necessary to support the overall increase in the scope of the Company's operations.

Non-operating Income

	1988	% Change	1987	% Change	1986
Non-operating income	$10.8	24	$8.6	69	$5.1
Percentage of net revenues	1.8%		2.5%		2.6%

Non-operating income includes investment income of $8.7 million, $7.3 million, and $3.2 million for fiscal years 1988, 1987, and 1986. Growth in investment income is attributable to a larger investment portfolio resulting from funds generated from operations and proceeds from the Company's initial public offering in March 1986. Results also include foreign currency transaction gains of $2.5 million, $1.7 million, and $2.0 million for fiscal years 1988, 1987, and 1986.

Stock Option Program Expense

Stock option programs were adopted by the Company during fiscal 1987 in response to the Tax Reform Act of 1986. As discussed in Note 7 of Notes to Consolidated Financial Statements, under these programs employees are paid a cash payment based on tax benefits the Company receives when the employees sell certain option stock or exercise certain options after having agreed to changes in the options' tax attributes.

As required by generally accepted accounting principles, the tax benefit realized from these programs ($11.6 million and $24.4 million for the years ended June 30, 1988 and 1987, respectively) is reported as a capital contribution. The cash payment from these programs is recognized as expense over the vesting period of the related stock options. For the year ended June 30, 1988, this resulted in stock option program expense of $14.5 million and a reduction of the provision for income taxes of $5.6 million related directly to the amount of expense recognized. For the year ended June 30, 1987, stock option program expense was $14.2 million with an income tax benefit of $8.0 million.

Through June 30, 1988, the total net benefit from these programs was $20.9 million. The total net benefit to be received from these programs depends on the market value of the Company's common stock and other factors and could aggregate between $30 and $60 million through 1992.

Provision for Income Taxes

	1988	% Change	1987	% Change	1986
Provision for income taxes	$59.8	21	$49.5	85	$26.7
Percentage of net revenues	10.1%		14.3%		13.5%
Effective tax rate	32.6%		40.8%		40.5%

For an analysis of the differences between the statutory and the effective income tax rates, see Note 6 of Notes to Consolidated Financial Statements. The decrease in the effective tax rate for fiscal year 1988 results from the Tax Reform Act of 1986, which lowered the top corporate tax rate from 46% to 34%.

In December 1987, the Financial Accounting Standards Board issued *Statement of Financial Accounting Standards No. 96—Accounting for Income Taxes.* The Statement, which is effective for the Company's fiscal year ending June 30, 1990, supersedes existing literature on accounting for income taxes in financial statements prepared in accordance with generally accepted accounting principles. Adoption of the Statement would not have had a material effect on the Company.

Net Income and Net Income Per Share

	1988	% Change	1987	% Change	1986
Net income	$123.9	72	$71.9	83	$39.3
Percentage of net revenues	21.0%		20.8%		19.9%
Net income per share	$2.22	71	$1.30	67	$0.78

Had the one-time stock option programs discussed above not been adopted, net income and net income per share would have been as follows:

	1988	% Change	1987	% Change	1986
Pro forma net income	$132.8	70	$78.1	99	$39.3
Percentage of net revenues	22.5%		22.6%		19.9%
Pro forma net income per share	$2.38	70	$1.40	79	$0.78

(In thousands, except net income per share)

	Year Ended June 30		
	1988	1987	1986
Net revenues	$590,827	$345,890	$197,514
Costs and expenses:			
Cost of revenues	148,000	73,854	40,862
Research and development	69,776	38,076	20,523
Sales and marketing	161,614	85,070	57,668
General and administrative	23,990	22,003	17,555
Total cost and expenses	403,380	219,003	136,608
Income from operations	187,447	126,887	60,906
Non-operating income (Note 1)	10,750	8,638	5,078
Stock option program expense (Note 7)	(14,459)	(14,187)	—
Income before income taxes	183,738	121,338	65,984
Provision for income taxes (Note 6)	59,830	49,460	26,730
Net income	$123,908	$ 71,878	$ 39,254
Net income per share	$ 2.22	$ 1.30	$ 0.78
Average common and common equivalent shares outstanding	55,818	55,270	50,400

See accompanying notes

Total assets at June 30, 1988 were $493.0 million, compared to $287.8 million and $170.7 million at June 30, 1987 and 1986. Over the last five years, total assets have grown at an annual rate of 83%.

Working capital at June 30, 1988 was $227.8 million compared to $164.4 million at June 30, 1987. The current ratios, the relationship of current assets to current liabilities, stood at 2.9 to 1 and 4.4 to 1 at the respective balance sheet dates. Significant increases in current liabilities accounted for the decline in the current ratio during fiscal 1988.

Working capital provided during fiscal 1988 totaled $153.2 million, of which $139.9 million was provided by operations. Another significant source of working capital was the $11.6 million tax benefit obtained by the Company as a result of the stock option programs discussed in Note 7 of Notes to Consolidated Financial Statements.

Working capital used during fiscal 1988 totaled $89.7 million, of which $71.6 million was used for additions to property, plant, and equipment and $12.4 million was used to acquire intellectual property rights. In March 1988, the Company completed construction of a 260,000-square-foot manufacturing and distribution facility in Snohomish County, Washington, at a cost of $10.5 million. In addition, the Company purchased equipment for this facility at a cost totaling $5.7 million. Also in March 1988, the Company began construction on a 230,000-square-foot office expansion to the corporate campus in Redmond, Washington. Through June 30, 1988, construction costs of this office expansion totaled approximately $10 million. In May 1988, the Company purchased undeveloped land adjacent to its corporate campus for $9.4 million. Corporate campus land owned or under long-term lease totaled approximately 125 acres at June 30, 1988. Purchases of computer equipment, including both personal and corporate systems, totaled approximately $24.3 million during fiscal 1988.

Cash and short-term investments grew $50.7 million during fiscal 1988 to $183.2 million and comprised 53% of current assets and 37% of total assets at June 30, 1988.

Working capital provided during fiscal 1987 totaled $103.6 million, of which $79.4 million was provided from operations. Another significant source of working capital was the $24.4 million tax benefit obtained by the Company as a result of the stock option programs.

Working capital used during fiscal 1987 totaled $57.7 million and was used almost entirely for additions to property, plant, and equipment. In August 1986, the Company purchased undeveloped land adjacent to its corporate campus for $5.3 million. In June 1987, the Company purchased land adjacent to its corporate campus for $21.8 million and land for a new manufacturing and distribution facility for $4.3 million. Also, during the fourth quarter of fiscal 1987, the Company completed construction on two corporate campus buildings at a total cost of approximately $10.4 million.

In November 1987, the Financial Accounting Standards Board issued *Statement of Financial Accounting Standards No. 95—Statement of Cash Flows*. The Statement, which is effective for the Company's fiscal year ending June 30, 1989, requires statements of cash flows in lieu of statements of changes in financial position.

(In thousands)

	June 30	
	1988	1987
Assets		
Current assets:		
Cash and short-term investments	$183,225	$132,484
Accounts receivable—net of allowance of $11,120 and $6,954	93,602	55,131
Inventories (Note 2)	53,542	16,555
Other	14,979	8,832
Total current assets	345,348	213,002
Property, plant, and equipment—net (Note 3)	130,108	70,010
Intellectual property rights—net	7,936	—
Other assets	9,627	4,742
Total assets	$493,019	$287,754
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 43,112	$ 20,526
Customer deposits and deferred revenue	6,038	6,289
Accrued compensation and employee benefits	15,057	5,127
Notes payable (Note 5)	20,259	5,172
Income taxes payable	16,051	2,217
Other	17,004	9,318
Total current liabilities	117,521	48,649
Commitments and contingencies (Notes 4, 7, and 9)	—	—
Stockholders' equity (Note 8):		
Common stock—$.001 par value; shares authorized 160,000; issued and outstanding 53,663 and 52,713	54	53
Paid-in capital	90,046	76,811
Retained earnings	285,014	161,106
Translation adjustment	384	1,135
Total stockholders' equity	375,498	239,105
Total liabilities and stockholders' equity	$493,019	$287,754

See accompanying notes

(In thousands)

	Preferred Stock		Common Stock		Paid-in Capital	Retained Earnings	Translation Adjustment	Total Stockholders' Equity
	Shares	Amount	Shares	Amount				
Balance, June 30, 1985	500	$5	43,067	$43	$ 5,080	$ 49,974	$ (662)	$ 54,440
Sale of stock in initial public offering	—	—	4,600	5	44,834	—	—	44,839
Conversion of preferred stock	(500)	(5)	2,000	2	3	—	—	—
Sale of stock, principally to employees	—	—	1,373	1	850	—	—	851
Net income	—	—	—	—	—	39,254	—	39,254
Translation adjustment	—	—	—	—	—	—	(52)	(52)
Balance, June 30, 1986	—	—	51,040	51	50,767	89,228	(714)	139,332
Sale of stock, principally to employees	—	—	1,673	2	1,696	—	—	1,698
Income tax benefit related to stock options (Note 7)	—	—	—	—	24,348	—	—	24,348
Net income	—	—	—	—	—	71,878	—	71,878
Translation adjustment	—	—	—	—	—	—	1,849	1,849
Balance, June 30, 1987	—	—	52,713	53	76,811	161,106	1,135	239,105
Sale of stock, principally to employees		—	950	1	1,681	—	—	1,682
Income tax benefit related to stock options (Note 7)		—	—	—	11,554	—	—	11,554
Net income	—	—	—	—	—	123,908	—	123,908
Translation adjustment	—	—	—	—	—	—	(751)	(751)
Balance, June 30, 1988	—	—	53,663	$54	$90,046	$285,014	$ 384	$375,498

See accompanying notes

(In thousands)

	Year Ended June 30		
	1988	1987	1986
Working capital provided			
Operations:			
Net income	$123,908	$ 71,878	$39,254
Depreciation and amortization	16,035	7,551	5,754
Total from operations	139,943	79,429	45,008
Common stock issued	1,682	1,698	45,690
Income tax benefit related to stock options (Note 7)	11,554	24,348	—
Long-term obligations	—	(1,879)	1,879
Total working capital provided	153,179	103,596	92,577
Working capital used			
Additions to property, plant and equipment (Note 3)	71,642	58,017	14,108
Acquisition of intellectual property rights	12,427	—	—
Translation adjustment	751	(1,849)	52
Other	4,885	1,527	1,407
Total working capital used	89,705	57,695	15,567
Increase in working capital	$ 63,474	$ 45,901	$77,010

	1988	1987	1986
Changes in elements of working capital			
Current assets - increase (decrease):			
Cash and short-term investments	$ 50,741	$ 29,808	$83,728
Accounts receivable	38,471	20,632	9,226
Inventories	36,987	8,547	2,089
Other	6,147	6,035	871
Current liabilities—(increase) decrease:			
Accounts payable	(22,586)	(10,755)	(5,959)
Notes payable	(15,087)	(5,172)	—
Income taxes payable	(13,834)	5,255	(6,221)
Other	(17,365)	(8,449)	(6,724)
Increase in working capital	$ 63,474	$ 45,901	$77,010

See accompanying notes

Presentation of Financial Information

Management's explanation and interpretation of the Company's overall operating results and financial position, with the basic financial statements presented in the preceding section, should be read in conjunction with the entire report. The Notes to Consolidated Financial Statements, an integral part of the basic financial statements, provide additional detailed financial information.

Management is responsible for the preparation of the Company's consolidated financial statements and related information appearing in this annual report. Management believes that the consolidated financial statements fairly reflect the form and substance of transactions and that the financial statements reasonably present the Company's financial position and results of operations in conformity with generally accepted accounting principles. Management has included in the Company's financial statements amounts based on estimates and judgments that it believes are reasonable under the circumstances.

The independent accountants audit the Company's consolidated financial statements in accordance with generally accepted auditing standards and provide an objective, independent review of the fairness of reported operating results and financial position.

The Board of Directors of the Company has an Audit Committee composed of non-management Directors. The Committee meets with financial management and the independent accountants to review accounting control, auditing, and financial reporting matters.

Francis J. Gaudette

Francis J. Gaudette
Vice President, Finance and Administration;
Treasurer; Chief Financial Officer

Report of Independent Accountants

To the Board of Directors and Stockholders of Microsoft Corporation:

We have audited the accompanying consolidated balance sheets of Microsoft Corporation and subsidiaries as of June 30, 1988 and 1987, and the related consolidated statements of income, stockholders' equity, and changes in financial position for each of the three years in the period ended June 30, 1988. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Microsoft Corporation and its subsidiaries as of June 30, 1988 and 1987, and the results of their operations and the changes in their financial position for the years then ended in conformity with generally accepted accounting principles.

Deloitte Haskins + Sells

Deloitte Haskins & Sells
Bellevue, Washington
July 25, 1988

Note 1. Significant Accounting Policies

Business. The Company's principal business activities are the development, production, marketing, and support of a wide range of software for business and professional use, including operating systems, languages, and application programs, as well as books and hardware for the microcomputer marketplace.

Principles of Consolidation. The consolidated financial statements include the accounts of Microsoft and its wholly owned subsidiaries. Significant intercompany transactions and balances have been eliminated.

Revenue Recognition. Revenue from sales of software and hardware consumer products to distributors or dealers is recognized when the products are shipped. Software products sold to original equipment manufacturers under license agreements generally provide for a commitment fee payable over a minimum commitment period of one to three years. When the product is accepted, the commitment fee is recognized as revenue ratably over the minimum commitment period or on a per unit basis if sales exceed the commitment fee level. Subsequent to the minimum commitment period, revenue based upon the number of systems shipped or copies sold is recognized as earned. Commitment fees received prior to product acceptance are recorded as customer deposits.

Short-term Investments. Short-term investments are carried at the lower of cost or market. Short-term investments at June 30, 1988 and June 30, 1987, consisted principally of municipal bonds, money market preferreds, and increasing rate notes.

Inventories. Inventories are stated at the lower of cost or market. Cost is determined using the first-in, first-out method.

Property, Plant, and Equipment. Property, plant, and equipment is stated at cost and depreciated using straight-line and declining-balance methods over estimated useful lives. Such lives are:

Buildings	30–35 years
Leasehold improvements	Lease term
Furniture and equipment	5 years
Computer equipment	5 years

Intellectual Property Rights. During the year ended June 30, 1988, the Company acquired intellectual property rights at net costs aggregating $12.4 million and recorded related amortization expense of $4.5 million. The costs of these rights are being amortized on the straight-line basis over their estimated useful lives, ranging from two to three years.

Warranties and Exchanges. The Company warrants products against defects and has policies permitting distributors and dealers to exchange products under certain circumstances. The Company's policies do not permit return of products to the Company for credit or refund. The Company's reserve for warranties and exchanges was $4.5 million and $2.0 million at June 30, 1988 and 1987.

Research and Development and Royalty Costs. A Financial Accounting Standards Board statement requires the capitalization of certain costs of producing software. Such costs are immaterial. Other research and development costs are expensed as incurred.

Cost of revenues includes royalties paid to authors of certain software products and publications under license agreements. Such royalties, which are based on net revenues, were $11.4 million, $9.8 million, and $6.1 million for the years ended June 30, 1988, 1987, and 1986.

Non-operating Income. Non-operating income includes investment income of $8.7 million, $7.3 million, and $3.2 million for the years ended June 30, 1988, 1987, and 1986. Results also include foreign currency transaction gains of $2.5 million, $1.7 million, and $2.0 million for the years ended June 30, 1988, 1987, and 1986.

Income Taxes. Income tax expense includes United States and foreign income taxes, including United States taxes on undistributed earnings of foreign subsidiaries. Certain items of income and expense included in the consolidated financial statements are reported in different years in the tax returns in accordance with applicable income tax laws. The resulting difference between the consolidated financial statement income tax provision and income taxes currently payable is reported in the consolidated financial statements as deferred income taxes. Tax credits are accounted for as a reduction of tax expense in the year in which the credits reduce taxes payable (flow-through method).

Foreign Exchange. Assets and liabilities denominated in foreign currencies are translated at the exchange rate in effect on the balance sheet date. Revenues, costs, and expenses are translated using an average rate. Translation adjustment resulting from this process is shown separately in stockholders' equity.

Exchange adjustments resulting from foreign currency transactions and realized and unrealized gains and losses on forward contracts used to hedge currency fluctuations are recorded in income. At June 30, 1988, the Company had approximately $30 million in contracts to exchange currency in the future.

Net Income Per Share. Net income per share is computed on the basis of the weighted average number of common and common equivalent shares outstanding and is adjusted for shares issuable upon exercise of stock options. The computation assumes the proceeds from the exercise of stock options were used to repurchase common shares at the average market price of the Company's common stock during each period.

Stock Split. On August 1, 1987, the Board of Directors declared a two-for-one split of the Company's common stock, effected in the form of a 100% stock dividend. All share and per share amounts have been restated to reflect the stock split retroactively.

Reclassification. The June 30, 1987, balance sheet reflects the reclassification of long-term liabilities of $2 million to other current liabilities resulting from the 1988 purchase of a facility under capital lease.

Note 2. Inventories

Inventories at June 30, 1988 and 1987 were as follows:

(In thousands)	June 30 1988	1987
Raw materials	$26,577	$ 8,465
Work in process	1,900	794
Finished goods	25,065	7,296
	$53,542	$16,555

Note 3. Property, Plant, and Equipment

Property, plant, and equipment at June 30, 1988 and 1987 were as follows:

(In thousands)	June 30 1988	1987
Land	$ 41,418	$31,437
Buildings	37,151	12,262
Leasehold improvements	6,101	3,909
Furniture and equipment	20,792	10,465
Computer equipment	54,777	30,524
	160,239	88,597
Accumulated depreciation	(30,131)	(18,587)
Property, plant and equipment—net	$130,108	$70,010

Note 4. Leases

The Company has operating leases for certain corporate campus facilities, field sales and development offices, and data processing and other equipment. The noncancelable corporate campus lease expires in 2001 with renewal options through 2011 and provides for rental adjustments based on a consumer price index. Rental expense for operating leases was $8.0 million, $5.4 million, and $4.5 million during the years ended June 30, 1988, 1987, and 1986.

At June 30, 1988, future minimum rental payments under noncancelable operating leases were (in thousands):

Fiscal Year	Minimum Rental Payments
1989	$ 9,887
1990	10,745
1991	9,409
1992	8,594
1993	7,198
1994 and thereafter	23,684
Total minimum payments	$69,517

Note 5. Notes Payable

Notes payable are borrowings under loan agreements, with financial institutions both domestic and abroad, totaling $40 million. The agreements require no compensating balances or commitment fees.

A summary of these borrowings follows:

(In thousands)	1988	1987
Average month-end borrowings	$15,817	$4,178
Weighted average interest rate	9.3%	8.8%
Maximum amount outstanding during the year	$35,322	$7,114
Weighted average interest rate at year-end	8.7%	7.8%

Note 6. Income Taxes

The income tax provision (benefit) is composed of:

(In thousands)	1988	1987	1986
Current	$69,170	$48,402	$30,949
Deferred	(9,340)	1,058	(4,219)
	$59,830	$49,460	$26,730

The deferred income tax provision (benefit) is composed of:

(In thousands)	1988	1987	1986
Cash basis tax accounting	$ (329)	$ (459)	$(2,659)
Reserves and expenses not currently deductible—net	(6,790)	(3,688)	(855)
Inventory adjustment	(5,145)	(1,127)	(705)
Undistributed foreign earnings	2,924	6,332	—
	$(9,340)	$ 1,058	$(4,219)

The Company's effective tax rate differs from the statutory rate as follows:

	1988	1987	1986
Federal statutory rate	34.0%	46.0%	46.0%
State income taxes	1.3	0.8	1.0
Tax exempt income	(1.1)	(1.8)	(1.4)
Foreign Sales Corporation	(1.7)	(1.1)	(2.0)
Tax credits	(1.8)	(2.8)	(1.4)
Other—net	1.9	(0.3)	(1.7)
	32.6%	40.8%	40.5%

Note 7. Stock Option Programs

The Tax Reform Act of 1986 diminished the cost-effectiveness of incentive stock options (ISOs) as an incentive compensation device. During the second half of the year ended June 30, 1987, the Company responded with two programs regarding its ISOs. One program, available to employees who had exercised certain options, provides a cash payment for their undertaking a "disqualifying disposition" of stock received upon exercise of the option. A second program, available to employees who held unexercised ISOs, provided them the opportunity to convert ISOs to nonqualified stock options (NSOs), with a cash payment upon exercise of the converted options. The Company receives a tax benefit upon the disqualifying disposition or exercise, and the cash payment to employees is 50% of the Company's benefit.

As required by generally accepted accounting principles, the tax benefit realized from these program ($11.6 million and $24.4 million for the years ended June 30, 1988 and 1987, respectively) is reported as a capital contribution. The cash payment from these programs is recognized as expense over the vesting period of the related stock options. For the year ended June 30, 1988, this resulted in stock option program expense of $14.5 million and a reduction of the provision for income taxes of $5.6 million related directly to the amount of expense recognized. For the year ended June 30, 1987, stock option program expense was $14.2 million with an income tax benefit of $8.0 million.

Note 8. Stockholders' Equity

Employee Stock Purchase Plan. The Company has an employee stock purchase plan for all employees. Under the plan, shares of the Company's common stock may be purchased at six-month intervals at 85% of the lower of the fair market value on the first or the last day of each six-month period. Employees may purchase shares having a value not exceeding 10% of their gross compensation during an offering period. During the years ended June 30, 1988 and 1987, shares totaling 152,179 and 68,888, respectively, were issued under the plan at average prices of $26.53 and $12.06 per share, respectively. At June 30, 1988, 378,933 shares were reserved for future issue.

Stock Option Plan. The Company has a stock option plan for officers and key employees that provides for nonqualified and incentive options. The Board of Directors determines the option price (not to be less than fair market value for incentive options) at the date of grant. The options generally expire five or ten years from the date of grant and are exercisable over the period stated in each option. At June 30, 1988, options for 803,858 shares were exercisable, and 864,475 shares were available for future grants under the Plan.

	Outstanding Options	
	Number	Price per Share
Balance, June 30, 1985	4,295,102	$0.24– 1.50
Granted	2,465,530	1.50–17.00
Exercised	(1,209,532)	0.24– 2.75
Expired	(532,012)	0.24– 1.50
Balance, June 30, 1986	5,019,088	0.24–17.00
Granted	2,114,000	13.50–52.50
Exercised	(1,681,582)	0.24– 2.75
Expired	(180,104)	0.24–52.50
Balance, June 30, 1987	5,271,402	0.24–52.50
Granted	3,649,585	33.36–58.13
Exercised	(926,211)	0.24–23.88
Expired	(413,515)	0.75–53.50
Balance, June 30, 1988	7,581,261	$0.24–58.13

Note 9. Litigation

On March 17, 1988, Apple Computer, Inc. brought suit against Microsoft and Hewlett-Packard Company for alleged copyright infringement. The complaint includes allegations that the visual displays of Microsoft Windows 2.03 infringe Apple's copyrights and exceed the scope of a 1985 settlement agreement between Microsoft and Apple. The complaint seeks to enjoin Microsoft from marketing Microsoft Windows 2.03 and from otherwise infringing Apple's copyrights and seeks damages in an unspecified amount resulting from the alleged infringement. The complaint also alleges that Microsoft is a contributory infringer as to a Hewlett-Packard product called New Wave.

Microsoft has answered the complaint, denying Apple's allegations that the visual displays in Windows 2.03 infringe any protectable right of Apple, raising affirmative defenses, asserting counterclaims, and seeking damages resulting from Apple's actions. Microsoft presently believes that the resolution of this matter will not have a material adverse effect on its financial condition as reported in the accompanying financial statements.

(In thousands)

	Information by Geographic Area				
	Domestic Operations	European Operations	Other Foreign Operations	Eliminations	Consolidated
1988					
Net revenues:					
Customers	$399,128	$144,825	$46,874	$ —	$590,827
Intercompany	52,520	97,100	245	(149,865)	
Total	451,648	241,925	47,119	(149,865)	590,827
Income from operations	131,246	56,328	838	(965)	187,447
Identifiable assets	398,167	150,215	26,107	(81,470)	493,019
1987					
Net revenues:					
Customers	$252,623	$ 68,307	$24,960	$ —	$345,890
Intercompany	26,496	46,548	3,237	(76,281)	—
Total	279,119	114,855	28,197	(76,281)	345,890
Income from operations	101,485	24,994	3,269	(2,861)	126,887
Identifiable assets	256,284	64,726	12,250	(45,506)	287,754
1986					
Net revenues:					
Customers	$161,287	$ 28,087	$ 8,140	$ —	$197,514
Intercompany	19,152	9,979	1,248	(30,379)	—
Total	180,439	38,066	9,388	(30,379)	197,514
Income from operations	55,353	6,151	1,015	(1,613)	60,906
Identifiable assets	169,230	27,830	12,837	(39,158)	170,739

The Company operates in one business segment–the development, production, marketing, and support of microcomputer software and related books and hardware peripheral devices. Intercompany sales between geographic areas are accounted for at prices representative of unaffiliated party transactions. Cost of revenues during the year ended June 30, 1986, includes $5.1 million paid to a foreign company whose major stockholder is a former director of the Company.

Domestic operations—net revenues from customers include export sales of $90.6 million, $53.0 million, and $43.8 million during the years ended June 30, 1988, 1987, and 1986. These export sales were made primarily to Europe and the Far East. Other foreign operations include subsidiaries in Australia, Canada, and Japan. Net revenues from foreign operations and export sales for fiscal years 1988, 1987, and 1986 were $282.3 million, $146.2 million, and $80.0 million. These amounts represent 47. 8%, 42. 3%, and 40. 5% of total net revenues for the respective years.

(In thousands, except per share data)

	Quarter Ended				
	Sept. 30	Dec. 31	Mar. 31	June 30	Year
1988					
Net revenues	$102,636	$155,896	$161,823	$170,472	$590,827
Income from operations	32,310	56,444	55,205	43,488	187,447
Net income	21,259	35,329	37,308	30,012	123,908
Net income per share	0.38	0.63	0.67	0.54	2.22
Common stock prices per share:					
High	66-5/8	79-1/4	65-1/2	67-1/2	79-1/4
Low	44-1/4	37-1/4	49-3/4	52-3/4	37-1/4
1987					
Net revenues	$ 66,780	$ 80,985	$ 98,363	$ 99,762	$345,890
Income from operations	25,605	30,910	37,914	32,458	126,887
Net income	15,824	19,697	19,100	17,257	71,878
Net income per share	0.29	0.35	0.35	0.31	1.30
Common stock prices per share:					
High	15-3/4	25-5/8	49-1/2	64-1/8	64-1/8
Low	13	13-3/4	23-3/4	45-1/4	13
1986					
Net revenues	$ 35,153	$ 49,897	$ 50,505	$ 61,959	$197,514
Income from operations	9,964	16,688	15,394	18,860	60,906
Net income	6,170	10,948	10,629	11,507	39,254
Net income per share	0.13	0.23	0.21	0.21	0.78
Common stock prices per share:					
High	—	—	14-7/8	17-3/4	17-3/4
Low	—	—	12-3/4	13-3/8	12-3/4

The Company has never paid cash dividends on its common stock. The Company's common stock has been traded on the NASDAQ National Market System since the Company's initial public offering in March 1986. On July 29, 1988, there were 6,852 holders of record of the Company's common stock.

(In thousands, except employee and per share data)

	Year Ended June 30				
	1988	1987	1986	1985	1984
For the year					
Net revenues	$590,827	$345,890	$197,514	$140,417	$97,479
Cost of revenues	148,000	73,854	40,862	30,447	22,900
Research and development	69,776	38,076	20,523	17,108	10,665
Sales and marketing	161,614	85,070	57,668	42,512	26,027
General and administrative	23,990	22,003	17,555	9,443	8,784
Income from operations	187,447	126,887	60,906	40,907	29,103
Non-operating income (loss)	10,750	8,638	5,078	1,936	(1,073)
Stock option program (expense)	(14,459)	(14,187)	—	—	—
Income before income taxes	183,738	121,338	65,984	42,843	28,030
Provision for income taxes	59,830	49,460	26,730	18,742	12,150
Net income	123,908	71,878	39,254	24,101	15,880
At year-end					
Current assets	345,348	213,002	147,980	52,066	37,947
Property, plant, and equipment—net	130,108	70,010	19,544	11,190	8,076
Intellectual property rights—net	7,936	—	—	—	—
Other assets	9,627	4,742	3,215	1,808	1,614
Total assets	493,019	287,754	170,739	65,064	47,637
Current liabilities	117,521	48,649	29,528	10,624	16,489
Long-term liabilities	—	—	1,879	—	436
Stockholders' equity	375,498	239,105	139,332	54,440	30,712
Total liabilities and equity	493,019	287,754	170,739	65,064	47,637
Working capital	227,827	164,353	118,452	41,442	21,458
Number of employees	2,793	1,816	1,153	910	608
Common stock data					
Net income per share	2.22	1.30	0.78	0.52	0.35
Book value per share	7.00	4.54	2.73	1.26	0.72
Cash and short-term investments per share	3.41	2.51	2.01	0.44	0.08
Average common and common equivalent shares outstanding	55,818	55,270	50,400	46,520	45,894
Shares outstanding at year-end	53,663	52,713	51,040	43,066	42,520
Key ratios					
Current ratio	2.9	4.4	5.0	4.9	2.3
Return on net revenues	21.0%	20.8%	19.9%	17.2%	16.3%
Return on average total assets	31.7%	31.4%	33.3%	42.8%	44.1%
Return on average stockholders' equity	40.3%	38.0%	40.5%	56.6%	70.0%
Growth percentages—increases					
Net revenues	70.8%	75.1%	40.7%	44.0%	94.7%
Net income	72.4%	83.1%	62.9%	51.8%	144.8%
Net income per share	70.8%	66.7%	50.0%	48.6%	150.0%
Book value per share	54.2%	66.3%	116.7%	75.0%	111.8%

Directors	William H. Gates	Chairman of the Board and Chief Executive Officer, Microsoft Corporation
	Jon A. Shirley	President and Chief Operating Officer, Microsoft Corporation
	David F. Marquardt	Partner, Technology Venture Investors
	Robert D. O'Brien	Chairman of the Board, PACCAR, Inc. (retired)
	Wm. G. Reed, Jr.	Chairman of the Board, Simpson Investment Company

Officers	William H. Gates	Chairman of the Board and Chief Executive Officer
	Jon A. Shirley	President and Chief Operating Officer
	Scott D. Oki	Senior Vice President, USA Sales and Marketing
	Steven A. Ballmer	Vice President, Systems Software
	Jeremy Butler	Vice President, International Operations
	Francis J. Gaudette	Vice President, Finance and Administration; Treasurer; Chief Financial Officer
	Joachim Kempin	Vice President, OEM Sales
	Richard C. MacIntosh	Vice President, Field Sales and Support
	Michael J. Maples	Vice President, Applications Software
	William H. Neukom	Vice President, Law and Corporate Affairs; Secretary
	Min S. Yee	Vice President and Publisher, Microsoft Press
	Steven W. Gray	Corporate Controller

Annual Meeting The Annual Meeting of Shareholders will be held on Friday, October 28, 1988 at 8:00 A.M., at the Bellevue Holiday Inn, 11211 Main Street, Bellevue, Washington.

Form 10-K Copies of Microsoft's Annual Report on Form 10-K are available upon written request from the Investor Relations Department, Microsoft Corporation, 16011 NE 36th Way, Box 97017, Redmond, Washington 98073-9717.

Common Stock Microsoft common stock is traded over the counter on the NASDAQ National Market Systems (MSFT).

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As a Company, Microsoft is committed to the use of our technology in the workplace. A variety of products were employed to create and produce this report, including both IBM and Macintosh versions of Microsoft Word, Microsoft Works, and Microsoft Excel. Information was gathered with the use of Microsoft's XENIX-based electronic mail system and page composition developed with Aldus® PageMaker®.

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